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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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| In the Matter of | ) | |
| | ) | CC Docket No. 93-193 |
| 1993 ANNUAL ACCESS TARIFF FILINGS | ) | |

# AT&T OPPOSITION TO DIRECT CASES

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August 24, 1993

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## SUMMARY

In the June 23 Order the Commission suspended various LEC access rates for one day and allowed them to take effect subject to an accounting order. The Commission also set a series of discrete issues for investigation and ordered the LECs to support their position on these issues.

In the Direct Cases filed in response to the June 23 Order certain LECs have failed to sustain their burden of justifying the reasonableness of the amounts and classifications of their access charges. Accordingly, the Commission should require these LECs to reduce access charges and, in the case of price cap companies, to revise the price cap indices ("PCIs") which support these access charges.

As shown in Part I, several price cap LECs have overstated their PCIs by improperly including as exogenous adjustments expenses associated with their SFAS 106 transition benefit obligation ("TBO") accruals for post-retirement benefits other than pensions ("OPEB"). The overall increase in price cap indices resulting from this adjustment is approximately $232 million, with an actual overstatement of rates of approximately $87 million.

The Commission has already determined that in order for OPEB accruals to be afforded exogenous price cap treatment the filing LEC must show that: (1) the costs are not within the carrier's control, and (2) the costs are not already reflected in the price cap formula. These LECs have not satisfied that standard. They have failed to show that the underlying OPEB TBO expense is not within their control and that they are not able to vary the level of OPEB benefits provided to their employees.

In addition, these LECs have not demonstrated that exogenous treatment of their SFAS 106 TBO accruals would not double count OPEB-related costs. Nothing contained in their respective Direct Cases refutes the fact that the ordinary workings of the price cap formula will allow the LECs to fully recover their OPEB TBO expense without exogenous treatment. As a result, the inclusion of the OPEB TBO as an exogenous cost will cause an intertemporal double count of these expenses.

As shown in Part II, NYNEX and SNET have overstated their proposed rates by improperly implementing the price cap sharing and low end adjustment mechanisms. NYNEX and SNET have adjusted their reported 1992 rate of return to exclude the impact of a low end formula adjustment. The effect of these revisions is to understate NYNEX's and SNET's sharing obligation by $21.9 million. SNET and NYNEX have provided no justification for their actions which deviate from the requirement of the Commission's Cost Support Order that carriers base sharing on annual earnings and which makes no provision for adjustments of this type.

In addition, U S WEST has understated its reduction in exogenous costs associated with the DEM transition by approximately $5.6 million. In its Direct Case, U S WEST has provided no basis to support its use of a formula which substantially deviates from the Commission's rules.

AT&T also showed that NECA's Common Line ("C/L") calculation is overstated by at least $3.4 million. This overstatement results from the participation in the C/L pool of twenty-six companies who, contrary to the Commission's GSF Order, have failed to reduce their traffic sensitive rates to compensate for GSF costs which they have shifted to the NECA C/L pool. Nonetheless, NECA continues to include the costs of these companies in its pool and has provided no principled basis to justify its failure to ensure compliance with the GSF Order.

In sum, these various LECs have failed to comply with the rules and orders of this Commission. As such, the Commission should require these companies to revise their rates prospectively and to refund the overstated amounts collected during the pendency of this investigation. In addition, the price cap LECs should be required to make downward adjustments to their PCIs.

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## AT&T OPPOSITION TO DIRECT CASES

Pursuant to the Commission's June 23 Order,[1] American Telephone and Telegraph Company ("AT&T") opposes the Direct Cases filed by certain local exchange carriers ("LECs") concerning their 1993 annual access tariffs. The Common Carrier Bureau has suspended these tariffs for one day and allowed them to take effect subject to the outcome of this investigation and an accounting order.[2] For the reasons discussed below, the Direct Cases of these LECs fail to justify the reasonableness of portions of their access tariffs. The Commission should therefore require these companies to revise their rates prospectively, to refund the overstated amounts collected during the pendency of this

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1 1993 Annual Access Tariff Filings, CC Docket No. 93-193, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, DA 93-762, released June 23, 1993 ("June 23 Order").

2 Id.

investigation, and, in the case of price cap companies, to reduce their PCIs.[3]

## I. THE PRICE CAP LECS SEEKING EXOGENOUS TREATMENT FOR THEIR OPEB ACCRUALS HAVE FAILED TO MEET THEIR BURDEN OF DEMONSTRATING THAT EXOGENOUS TREATMENT IS JUSTIFIED.

AT&T's Petition addressed to the 1993 annual access tariff filings[4] showed that most of the price cap LECs have overstated their price cap indices based on unjustified exogenous adjustments associated with their SFAS 106 transition benefit obligation ("TBO") accruals for other post-retirement benefits or "OPEB."[5] The price cap

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[3] Appendix A identifies the companies whose tariff rates and PCIs should be remedied.

[4] Petition of American Telephone and Telegraph Company, 1993 Annual Access Tariff Filings, filed April 27, 1993, pp. 1-20 ("AT&T Petition").

[5] Based on a change in generally accepted accounting principles ("GAAP") known as "SFAS 106," all LECs were required to change their method of accounting for other post-retirement benefits (principally the health care benefits paid to retired employees) from a cash to an accrual basis no later than January 1, 1993. See Statement of Financial Accounting Standards No. 106 (Financial Accounting Standards Board, Financial Accounting Series No. 098-D, December 1990) ("SFAS 106"); Southwestern Bell and GTE Service Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions", 6 FCC Rcd. 7560 (¶ 3)(1991)("SFAS 106 Adoption Order"). Prior to SFAS 106, companies accounted for OPEBs on a cash or "pay-as-you-go" basis, recognizing the benefit amounts actually paid to retired employees in the current accounting period. SFAS 106 requires companies to account for ongoing OPEB costs on an accrual basis, in effect treating them as a form of deferred compensation

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LECs have previously sought and the Commission in the OPEB Order has denied exogenous treatment for their SFAS 106 OPEB accruals.[6] In their 1993 filings, certain price cap carriers[7] again sought exogenous treatment; in aggregate, these companies have included $232 million of exogenous OPEB-related increases to their price cap indices for the July 1, 1993 to June 30, 1994 tariff period.[8] These

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earned by employees during their working years (OPEB Order, ¶ 3). SFAS 106 additionally requires companies to recognize on their books the amount of their unfunded OPEB obligation for retired and active employees existing as of SFAS 106 adoption. This unfunded obligation is referred to as the "transition benefit obligation" or "TBO" (id., ¶ 4).

6 Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers' Accounting for Postretirement Benefits Other Than Pensions", 8 FCC Rcd. 1024 (¶¶ 1, 40, 53-60)(1993)("OPEB Order"). The OPEB Order concluded an earlier investigation ("1992 OPEB Investigation"), to which all of the then price cap LECs were joined as parties.

7 Of the companies already under price cap regulation, Ameritech, Bell Atlantic, BellSouth, GTOCs, GTE System (Contel), NYNEX, Rochester, SNET, SWBT and U S WEST sought exogenous treatment for OPEB in their 1993 annual access filings; Nevada Bell, Pacific Bell and United did not. (Nevada Bell and Pacific Bell have nevertheless addressed SFAS 106 in their instant Direct Cases.) Two companies, Centel and Lincoln, elected to adopt price cap regulation in their 1993 annual filings; Lincoln sought exogenous OPEB treatment, whereas Centel did not.

8 The $232 million worth of increases includes significant retroactive amounts, totaling $99 million. NYNEX, Rochester, SWBT and U S WEST include costs back to January 1, 1993, the mandatory adoption date of SFAS 106; Bell Atlantic includes costs back to January 1, 1991,

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companies have again failed, however, to meet their burden of demonstrating that exogenous treatment of these expenses is justified.[9]

The price cap system of regulation was designed to promote LEC productivity, by regulating only the amount that the LECs can charge for their services and letting each LEC's profitmaking incentives cause it to exert downward pressure on its internally controllable costs.[10] As the Commission explained in the OPEB Order (¶ 48),

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when it voluntarily adopted SFAS 106. Inclusion of SFAS 106 costs for any period prior to the current tariff period (July 1, 1993 to June 30, 1994) violates the Commission's policy against retroactive ratemaking. Nader v. FCC, 520 F.2d 182, 202 (D.C. Cir. 1975). Moreover, Bell Atlantic's adoption of SFAS 106 prior to its mandatory adoption date is a purely voluntary decision of the carrier and therefore would not in any event qualify for exogenous treatment. See AT&T Revisions to Tariff F.C.C. Nos. 1, 2 and 13, 5 FCC Rcd. 3680 (1990)("AT&T SFAS 106 Order"). In contrast to these companies, Ameritech, BellSouth, GTOCs, GTE System (Contel), Lincoln and SNET include only prospective tariff period costs in their filings. See Appendix B-1 for a breakdown of the exogenous treatment for OPEB requested by the price cap LECs.

9 The LECs bear the burden of demonstrating that a GAAP change should be given exogenous price cap treatment. June 23 Order, ¶ 7; OPEB Order, ¶ 52, citing LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2663-65, 2668.

10 Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786, 6787, 6789, 6790 (¶¶ 1, 2, 22, 31)(1990)("LEC Price Cap Order"), recon. denied, 6 FCC Rcd. 2637 (1991)("LEC Price Cap Reconsideration Order"), petition for review pending sub

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> "The concept of incentive regulation is that an administratively simple mechanism of maximum prices, combined with a widened range of allowable profits, will provide encouragement for the carrier to make business decisions as a competitive firm would, in the knowledge that its earnings will in substantial part and over the long term be determined by how effective those decisions are. In deciding whether a cost change should be endogenous or exogenous, we have sought to maintain this incentive."

Indeed, "the touchstone for the Commission in determining whether a change should be afforded exogenous treatment has been consistency with the incentive structure of the price cap plan." Id. Consistent with its goal to foster efficiency, the Commission has already concluded in the OPEB Order that for the OPEB TBO accrual to be accorded exogenous price cap treatment, the LEC must show both that: (1) the costs are not within the carrier's control, and (2) the costs are not reflected in the price cap formula (id., ¶ 52).[11]

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nom. D.C. Pub. Serv. Comm'n v. FCC, No. 91-1279 (D.C. Cir. filed June 14, 1991).

[11] Applying this test, the Commission concluded that ongoing OPEB costs are not entitled to exogenous treatment because of the substantial control that LECs have over their ongoing health care benefit plans (OPEB Order, ¶¶ 53-55). Furthermore, the Commission denied exogenous treatment for the OPEB TBO without determining whether the LECs could control this cost, because no LEC had shown that this cost was not already reflected in the price cap formula (id., ¶¶ 59-60). The OPEB Order (¶ 76), however, permitted the LECs to provide better

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The LECs in their Direct Cases have not met this test.[12] First, they have failed to show that the underlying OPEB TBO expense is not within their control and that they are not able to vary the level of benefits provided to their employees. Second, they have not demonstrated that their SFAS 106 TBO accruals do not double count OPEB-related costs that will be otherwise recovered through the price cap formula.

A. These LECs Have Not Shown That They Lack The Ability To Control The Benefit Costs Represented By The TBO.

The Commission has found that only those costs that are outside of the LEC's control qualify for exogenous treatment.[13] Certain of the LECs erroneously contend that they "lack control" over the OPEB TBO because adoption of SFAS 106 accrual accounting is mandatory.[14] The Commission

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support for exogenous treatment for the TBO amounts in their 1993 annual access filings.

[12] Although the LECs failed to meet this test in their April 2, 1993 annual access filings, rather than resolving the issue on its merits, the Bureau's June 23 Order (¶ 105(1)) designated for yet another investigation the question of whether "the LECs [have] borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change . . .?"

[13] LEC Price Cap Order, 5 FCC Rcd. at 6787 (¶ 5).

[14] See, e.g., Ameritech, p. 2; BellSouth, p. 4; GTE, p. 8; NYNEX, p. 2 and Ex. 1, p. 2 of 31; Pacific, p. 3; Rochester, p. 6; SNET, p. 3; SWBT, p. 9; U S WEST, p. 4.

has rejected this position, and has held that the LECs must show that they cannot control the underlying costs represented by the TBO.[15] In the OPEB Order (¶ 53), the Commission explicitly ruled that "a lack of control over the regulatory action is not enough of a showing to justify exogenous treatment."[16]

The OPEB Order allowed the LECs a further opportunity in their 1993 access filings to present evidence that they lack control over the expenses underlying the OPEB TBO. The evidence presented in their Direct Cases confirms that the LECs do have the ability to influence and control the cost of benefits represented by the TBO; control that negates exogenous treatment.

The TBO represents the accrued amount of unfunded OPEB benefits "promised" to employees and retirees before

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[15] Contrary to the LECs' protestations (see n.14, supra), the Commission's decision in the OPEB Order to require the LECs to show that the underlying OPEB TBO expense is beyond their control comports fully with earlier Commission decisions to treat a variety of costs endogenously to assure "consistency with the incentive structure of the price cap plan." OPEB Order, ¶¶ 48-49 (e.g., depreciation expense, international settlements, earthquake and hurricane costs, migration of IXC POPs) (citations omitted).

[16] OPEB Order, ¶ 53. As the Commission found, if carriers are able to control their retiree health care costs, a grant of exogenous treatment would "give the LECs undue power to influence their PCI levels, and would undermine the incentive structure of price caps." Id.

SFAS 106 took effect.[17] As the Commission correctly recognized, "[t]he extent to which [the LECs] can control changes in these [benefit] plans . . . depends upon the specific terms of their . . . contracts." Id., ¶ 58. This is because although an employer and its employees may contract for post-retirement medical benefits, there is no statutory entitlement to such benefits under ERISA.[18] Thus, if an employer reserves its right in governing plan documents to modify the terms of its medical plan, it will generally be permitted to modify the level of benefits paid even to retired employees.[19] This is true not only for management employees, but also for those employees subject to labor contracts: for collectively bargained employees, retiree medical benefits that are explicitly limited to the duration of the collective bargaining agreement may be reduced or discontinued upon expiration of that agreement.[20]

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[17] OPEB Order, ¶ 57.

[18] See, e.g., In re White Farm Equipment Co., 788 F.2d 1186, 1193 (6th Cir. 1986). Nothing in ERISA precludes an employer from changing or withdrawing OPEBs from its employees or retirees.

[19] See, e.g., Moore v. Metropolitan Life Ins. Co., 856 F.2d 488 (2d Cir. 1988); see also Musto v. American General Corp., 861 F.2d 897 (6th Cir. 1988), cert. denied, 490 U.S. 1090 (1989)(medical benefits do not "vest" at retirement).

[20] See, e.g., Senn v. United Dominion Industries, Inc., 951 F.2d 806, 814, reh. denied 962 F.2d 655 (7th Cir. 1992), cert. denied, 113 S.Ct. 2992 (1993); United Paperworkers Union v. Jefferson Smurfit Corp., 961 F.2d. 1384 (8th

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The evidence demonstrates that the LECs have, in fact, broadly reserved the right to modify or terminate these benefits altogether, and thus they have the ability to control the TBO expense. Rochester (p. 6), for one, specifically admits that it can "-- and does -- exercise control over its retiree health care costs." GTE (p. 22) likewise concedes that it has expressly reserved the right to terminate or change its benefit plans. Most fundamentally, the LEC medical plan summaries and labor contract provisions filed in response to the June 23 Order confirm that each of the other price cap carriers (who has included exogenous OPEB costs in its 1993 annual filings) has similarly reserved the right to modify or terminate its benefit plans.[21]

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Cir. 1992); Box v. Coalite, Inc., 643 F. Supp. 709 (N.D. Ala. 1986).

[21] See, e.g., Ameritech, Att. 1, Ex. 1, p. 2 of 6 (1992 Health Care Plan: "The Company . . . reserves the right to amend or terminate the plan at any time with respect to retirees, employees and their dependents."), Ex. 2, pp. 2, 4, 10, 11, 13, 15, 18, 28 (Labor Contracts: promises as to benefits limited to "the term of the Agreement"); Bell Atlantic, Ex. 2 (1992 Memorandum of Understanding and Tentative Bargaining Agreements show OPEB subject to capping and renegotiation; Salaried Employees' Management Bulletin, p. 10, contains broad reservation of rights); BellSouth, App. A, Ex. 1, pp. i, 50 (Medical Assistance Plan states "BellSouth . . . reserves the right, at its discretion, to amend, reduce, or terminate the Plan and coverage at any time for active, retired, or former employees and all dependents, subject to applicable collective bargaining

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The LECs suggest, however, that significant considerations, such as labor relations, public relations, principles of ethical behavior, and the ability to attract and retain qualified employees, impose practical limits on their ability to alter the retiree benefits represented by the OPEB TBO.[22] AT&T does not disagree with this observation, but it is irrelevant to the issue of "control"

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agreements."), App. A, Ex. 5, p. 208 (Labor Contract, promise limited to "term of Agreement"); GTE, p. 22 (admits control and cites broad reservation of rights clauses); Lincoln, p. 3 (cites broad reservation of rights clause); NYNEX, Ex. 1, App. B, Atts. 1 and 5, p. 1, A(3) (Management and Nonmanagement Medical Expense Plans each contain broad reservation of "right to terminate or amend the plan"); Rochester, p. 6 (admits control); SNET, App. B, pp. 1-2 (Nonmanagement and Management Medical Plans both with broad "right to amend and modify"); SWBT, Apps. C, D and E (Nonmanagement, Management and Retirement Benefit brochures all reserve "the right to end or amend any [plan] at anytime and for any reason"); U S WEST, Att. 2, p. 1 (U S WEST states that for retirees after 1990, its documents reserve right to amend or terminate retiree health benefits, with the exception of persons who took an Enhanced Retirement Offer; and CWA contract controls benefits until mid-1995, in other words, only during term of the Agreement).

The price cap LECs' brochures and contracts are consistent with those of many other companies. In a recent survey of 306 companies that provide retiree medical benefits, 92% reported that their plan documents expressly reserve to the employer the right to amend or terminate the plan. 1992 Hay/Huggins Survey, <u>Trends in Retiree Medical Benefits</u>, p. 11.

[22] <u>See</u>, <u>e.g.</u>, Ameritech, p. 3; GTE, pp. 11-12; NYNEX, Ex. 1, pp. 3, 17 of 31; SWBT, pp. 11-15.

for purposes of exogenous treatment. The OPEB TBO expense is no different in this respect than salaries and wages and ongoing OPEB benefits, which LEC management "sets" or "bargains for" in light of economic and a myriad of other pertinent considerations (including employee satisfaction) in the efficient operation of the carrier's business. The fact that external considerations such as those cited by the LECs affect management decisionmaking as to the OPEB TBO does not place this cost outside of the carrier's control.[23]

There are a variety of ways in which LECs can control the OPEB costs represented by the TBO. The OPEB Order (¶ 54) identified managed care arrangements, flexible benefit plans, outpatient treatment, and generic prescription drug programs. Additional cost-control measures include, for example, use of defined-dollar plans, sharing costs with retirees, tying employee contributions to

[23] To supply carriers with the proper efficiency incentives, the Commission has mandated endogenous treatment for other costs over which carrier control is far more attenuated than the company-provided OPEB benefits at issue here. For example, the Commission has required endogenous treatment of AT&T's international settlement rates to provide AT&T the proper incentive to negotiate lower rates. Also, extraordinary costs caused by earthquakes and hurricanes are treated endogenously so that carriers will have the proper incentives to prepare and cope with such unforeseen costs. OPEB Order, ¶ 49 (citations omitted).

inflation, and requiring employee prefunding.[24] Indeed, the LECs' filings confirm that some of these companies have already exercised their management prerogative to implement cost control measures through capping OPEB medical benefit payment levels or imposing cost-sharing requirements on their employees.[25] The fact that the LECs have taken such measures is a clear indicia of the carrier's ability to control these costs in a reasonable manner.

In short, the LECs have failed to satisfy the first prong of the Commission's test for exogenous treatment, i.e., that they do not have the ability to control TBO costs. In these circumstances, exogenous treatment for the TBO would be inconsistent with the incentive structure of price caps, because the

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[24] Other cost-containment options were described in AT&T's Petition, at Appendix B-2. See also OPEB Order, ¶ 54.

[25] OPEB Order, ¶ 55. See, e.g., Bell Atlantic, Ex. 2 (1992 Memorandum of Understanding, 1992 Tentative Bargaining Agreement, and Salaried Employees' Management Bulletin); BellSouth, App. A, Ex. 1 (Medical Assistance Plan, pp. 12, 50); GTE, p. 12; NYNEX, Ex. 1, pp. 19-20; SNET, p. 4; SWBT, pp. 15-18; U S WEST, Att. 2, Ex. C-3 (Health Care Caps). See also, e.g., 1993 Annual Access Filings, Ameritech, D&J p. 14; GTOCs, D&J pp. 17-18; SWBT, D&J pp. 3-16 to 3-17; and the Direct Cases in the 1992 OPEB Investigation, CC Docket No. 92-101, filed June 1, 1992, by Ameritech, p. 21; Bell Atlantic, p. 26; BellSouth, pp. 18-19; Pacific, p. 18 and App. 7 p. 20.

administration and delivery of health care benefits is an area ripe for further productivity improvements.[26]

B. These LECs Have Not Shown That Their Exogenous Adjustments For SFAS 106 TBO Expenses Will Not Result In A "Double Count" Of OPEB-Related Costs.

The LECs' request for exogenous treatment of their SFAS 106 TBO accruals should also be denied for the additional independent reason that the "LECs have failed to meet their burden of proving that the TBO meets the second prong of the [price cap] test."[27] As the Commission correctly recognized, double recovery of OPEB expenses will occur unless the "carriers can show that the cost change at issue is not reflected in the PCI."[28] To demonstrate that no double counting will occur the LECs "must show that the cost change has a unique or disproportionate effect on the price cap companies." OPEB Order, ¶ 60.

The LECs have failed to satisfy this test. As the Commission has explained, the accelerated recognition of OPEB costs for financial statement purposes required by

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[26] As the Commission has previously recognized, granting exogenous treatment to an expense could create perverse incentives for the LECs to inflate that expense, contrary to the Commission's goals to encourage carriers to control their administrative costs. LEC Price Cap Order, 5 FCC Rcd. at 6790 (¶ 31); LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2666-67 (¶ 66).

[27] OPEB Order, ¶ 59.

[28] OPEB Order, ¶ 60.

SFAS 106 has no true economic impact on any firm. SFAS 106 is an accounting change; it does not alter a firm's economic costs of providing OPEB benefits or increase cash outlays. All that SFAS 106 requires is that, for financial reporting purposes, OPEB expenses be accrued. As the OPEB Order (¶¶ 70, 74) stated, SFAS 106 implementation "does not change the size or nature of OPEB payments of LECs or other firms to their present or future retirees" but "only the time at which they are recorded in company accounts, so as to better inform investors of the extent of the company's liabilities."[29] Moreover, as the OPEB Order (¶ 74) further noted, SFAS 106 "does not change the actual flow of benefits payments the companies make over time."[30]

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[29] Accord Rochester, p. 7; GTE, p. 20. The investment community fully agrees with these conclusions that SFAS 106 adoption is not an economic or cash flow-affecting event. See Duff & Phelps, Credit Decisions, October 9, 1989, p. 8 (". . . [I]t is important to understand that financial statement recognition of the OPEB liability does not constitute an economic event.") See also Moody's March 1991 Special Comment on SFAS 106, p. 3 ("We must recognize that the new reporting, as it involves accrual accounting, is not expected to change our assessment of the prospective cash flow of companies.")

[30] The LECs nevertheless contend that their economic studies show that they will be disproportionately impacted by SFAS 106 because the current level of their OPEB TBO costs are not reflected in GNP-PI. (See, e.g., BellSouth, p. 5; GTE, pp. 14-16; NYNEX, Ex. 1, pp. 22-23 of 31; SNET, p. 5; U S WEST, pp. 6-7.) However, the Commission has previously concluded that the Godwins and NERA Studies, which the LECs presented in the 1992 OPEB Investigation and on which they continue to rely in this proceeding, "are flawed in several significant

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Because SFAS 106 does not impose any new economic burden on the LECs, the Commission properly concluded in the OPEB Order (¶ 67) that the ordinary working of the price cap formula allows the LECs to recover their OPEB TBO expenses without any exogenous treatment. This recovery of OPEB TBO expenses occurs for two reasons. First, pay-as-you-go OPEB expenditures made by the price cap LECs while they were under rate of return regulation were included in the LECs' initial price cap rates. Therefore, changes in the level of pay-as-you-go OPEB expenditures as well as all other endogenous cost changes are captured in the price cap formula, which allows LEC rates to rise in conjunction with GNP-PI.[31] Second, there is no difference whatsoever between

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respects. . . ." OPEB Order, ¶¶ 60, 63. Although the LECs provided an expanded sensitivity analysis for the Godwins Study in their 1993 annual access filings, as AT&T's Petition (pp. 15-19) showed, that does not cure the fundamental defects of the study. In short, there have been no changes in the evidentiary record that would warrant reversal of the OPEB Order and allow the Commission to conclude that the costs associated with the OPEB TBO are not reflected in the GNP-PI.

[31] The Commission chose GNP-PI as a measure of inflation that most closely mirrors overall cost changes in the factors of production. See LEC Price Cap Order, 5 FCC Rcd. at 6792-93 (¶¶ 50-52). As such, it follows that some costs of production will rise faster, and others slower, than GNP-PI, because GNP-PI represents a "market basket" of all factors of production. As the Commission explained in the OPEB Order (¶ 61), "there is not necessarily a precise correspondence between any endogenous cost change [e.g., pay-as-you-go costs] and the extent to which it is reflected in GNP-PI." Rather,

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pay-as-you-go expense and the OPEB TBO expense over time.[32] For these reasons, and as at least two of the companies concede, the normal operation of the price cap formula over time will compensate the LECs for their OPEB TBO expenses, without exogenous treatment being necessary.[33]

As such, exogenous treatment of the TBO would necessarily "introduce . . . double counting: the immediate recovery of these costs (on an accrual basis) as an exogenous change, and the recovery over time of these costs in the GNP-PI - X adjustments to the PCIs."[34] Accordingly,

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the "rough justice" nature of GNP-PI compensates the LECs overall for inflation. Id.

32 This is because the purpose of SFAS 106 is to reflect the present value of future projected pay-as-you-go expenses. See Appendix B-2 which shows, in numerical terms, that the dollar amount of pay-as-you-go expenses and OPEB TBO expenses are equal over time.

33 Accord, NYNEX, p. 23; Rochester, p. 3. NYNEX and Rochester suggest that the issue is whether exogenous treatment or pay-as-you-go increases provide for better "timing" of the recovery of OPEB expense. The timing issue is irrelevant because, under the second prong of the Commission's test, exogenous treatment will be allowed only if the cost change is not already reflected in the PCI. Here, as these carriers admit, recovery will occur over time through the normal operation of the price cap plan.

34 OPEB Order, ¶ 67. SWBT (pp. 37-40) mistakenly asserts that the present value of the SFAS 106 expense is significantly higher than under pay-as-you-go accounting and that therefore additional rate treatment is needed. SWBT's conclusions are based on a fundamentally erroneous use of the present value concept. Present value, when

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an annual adjustment mechanism that will over time undo the rate impact of any exogenous treatment would be required to remove this intertemporal double count effect.[35] Although several LECs[36] have expressed a willingness to make annual adjustments, none of their proposed approaches accounts for the double count that would occur if exogenous treatment were granted.[37] Moreover (even if they did), the fact remains that, as the Commission has already found, an annual true-up mechanism would be burdensome and complex, and thus

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properly used, is applied to a cash stream in order to calculate its time value and make valid comparisons with other cash streams. SWBT misapplies present value to the accrued SFAS 106 cost, which is not cash-affecting. SWBT's displays (p. 38) are therefore incorrect and misleading. Indeed, the purpose of SFAS 106 is to present value, in today's dollars, future projected pay-as-you-go expenses. As such, the present value of the stream of payments must equal the SFAS 106 accrual. SWBT also presents a scenario where a LEC would make no cash outlays for OPEBs until the last year of the accrual. This understates the present value of the pay-as-you-go expenses. No LEC has provided any evidence that it will pay for retiree benefits only at the end of the accrual period, as SWBT assumes.

[35] Bell Atlantic (pp. 3-4) contends that there is no intertemporal double count because its TBO is "an actuarially-determined cost, based on a count of actual employees." As shown in Appendix B-2, Bell Atlantic is wrong because exogenous treatment of the TBO will result in a substantial intertemporal double count over time, even if the TBO is actuarially correctly determined.

[36] See, e.g., GTE, pp. 13, 18; NYNEX, Ex. 1, p. 23 of 31; Rochester, p. 12; SWBT, p. 22.

[37] See Appendix B-2.

inconsistent with the price cap policy of administrative simplicity.[38]

Not only have the LECs failed to show the absence of a double count (as required by the OPEB Order), further support for denial of exogenous treatment comes from the fact that the LECs' accrued OPEB costs are already fully reflected in their current earnings. Pursuant to various Commission rulings, both price cap and rate of return LECs have reflected their SFAS 106 TBO accrual as a cost on their regulated income statements (LEC Form 492 - Rate of Return

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[38] OPEB Order, ¶¶ 48 and 69. Indeed, the LECs' offer to make annual adjustments overlooks the point that, as shown in Appendix B-2, the entire exogenous adjustment would be double counted. This is because only the time pattern, but not the present value of costs associated with the TBO, is affected by the change from cash to accrual accounting. Therefore, treating the accounting change as an exogenous event would require a positive price adjustment followed by an extended period of negative price adjustments, with the adjustments canceling out in present value. Such a change in timing provides the LECs with no net gain on their cost recovery, at the cost of great complexity. Moreover, even if an appropriate annual adjustment mechanism were developed to remove the intertemporal double count, given the size of the OPEB TBO, an annual adjustment could create excessive rate volatility and rate churn, which the Commission regards as undesirable. See 1992 Annual Access Tariff Filings, 7 FCC Rcd. 4731, 4735 (¶ 13)(1992) ("1992 Tariff Order"). Thus, the Commission should not burden the price cap plan with "a complex addition" to remove the intertemporal double count, rather it should deny exogenous treatment because the price cap mechanism "will permit LECs to recover all OPEB expenses over time." OPEB Order, ¶ 69.

Report).[39] Even with the accrued OPEB expense already reflected on their earnings reports, most of the price cap LECs are earning at levels that have required them to make "sharing" adjustments in their 1993 annual access filings.[40] Given this fact, the LECs are in no position to claim that failure to receive exogenous treatment would be unfair. In addition, even if the LECs' earnings picture were to change, the "low end adjustment" backstop mechanism of the LEC price cap formula fully protects the price cap LECs against earnings erosion.[41] Therefore, both a correct analysis of the double count and equity indicate that the LECs should not be given exogenous treatment for the SFAS 106 TBO. As such, the LECs should be required to revise their PCIs to remove exogenous adjustments for their SFAS 106 TBO accruals.

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[39] See SFAS 106 Adoption Order, supra, and Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, 7 FCC Rcd. 2872 (1992) ("RAO Letter 20"). Under RAO 20, the Bureau authorized the LECs to amortize the SFAS 106 TBO over a 20-year service period or the average remaining service period of active plan participants.

[40] Appendix B-3 identifies the LECs that filed sharing adjustments in their 1993 access filings.

[41] In the 1993 filings, lower formula adjustments are found only in a few GTE jurisdictions.